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C O N F I D E N T I A L SECTION 01 OF 02 ANKARA 002292

SIPDIS

STATE FOR E, P, EUR/SE AND EB
TREASURY FOR U/S TAYLOR AND OASIA - MILLS
NSC FOR QUANRUD AND BRYZA

E.O. 12958: DECL: 09/02/2006

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SUBJECT: TURKEY'S ECONOMY APRIL 9: NEWS OF U.S. AID
"CONDITIONALITY" DAMPENS MARKET MOOD; TREASURY CHIEF UNDER
PRESSURE

REF: ANKARA 2258

Classified by Econ Counselor Scot Marciel for reasons 1.5 (b,
d).

Markets - U.S. Senate "Conditionality" A
Negative Surprise

1. (U) On April 9 am, in the first trading session for the new T-bill issued yesterday, volume was quite high - TL 1.1 quadrillion (\$670 million). Rates, however, did not decline as expected. Traders cited the local press reports that the Senate version of the U.S. aid for Turkey contains a condition that Turkey not intervene in Northern Iraq, a condition that the GOT is bound to contest, per some market contacts.

-- T-bill yields rose about 0.5 percent to 63.5 percent compounded.

-- The lira depreciated slightly to TL 1,647,000;

-- The Istanbul Stock Exchange closed down 2.4 percent in morning trading.

Treasury Undersecretary Personally Unhappy, But
Still Sees Positive Prospects for the Economy

2. (C) Treasury Undersecretary Faik Oztrak, whom local press is speculating will be replaced shortly (reftel), was clearly unhappy in his April 8 meeting with Econ Counselor. Oztrak began by noting the Government's continuing credibility problem in the financial markets. "This government doesn't understand," he said citing as an example PM Erdogan's April 8 meeting with AK parliamentary deputies. Erdogan gave a good statement about this GOT's determination to continue the reform program started by the prior government. But then, per Oztrak, Erdogan also said this GOT will restructure state bank Ziraat's loans to farmers (note: news reports say Erdogan offered to extend overdue debts for three years or slash debts by 30 percent if repaid in lump sums.) This populist signaling undercuts the GOT's tough fiscal measures, and makes it harder to reduce interest rates on GOT debt, Oztrak said.

4. (C) Moving to his situation, Oztrak said the Government doesn't ask his advice on personnel appointments, including the recent state bank board appointments, even though the Treasury oversees the state banks. Oztrak would have advised against replacing the entire state bank board at this sensitive time. Furthermore, Oztrak said he doubted he would go to Washington for the spring Bank and Fund meetings. He was invited to address a JP Morgan seminar in Washington, but Babacan had balked, saying Oztrak needed Prime Ministerial approval to talk at this seminar. "I told Minister Babacan I don't want to be a lame duck Treasury Undersecretary. Either I have full responsibility and authority or they appoint someone else."

5. (C) Oztrak said he would given a positive portrayal in Washington. The government had put forth a strong budget and is implementing it. Turkey's economy is very resilient and responds quickly to reforms. Furthermore, if the GOT maintains its partial spending freeze (about TL 4 quadrillion) until the fourth quarter, it will be able to finance itself at lower rates. The TL 4 quadrillion will help reduce the market roll-over rates for Turkey's debt to 75 percent (from current 85-90 percent). As roll-over demands start to decrease, Treasury will calibrate the supply

of new debt issuances to ensure a gradually decreasing interest rates on these securities. Under conservative projections of the new interest rate path, and also assuming Turkey uses the U.S. loan package to help service domestic debt, the net public sector debt to GNP ratio should decline to 73 percent by year-end 2003 (from nearly 80 percent at year-end 2003). In addition, the composition of the holders of Turkey's domestic debt is changing - about one third of the marketable part of the domestic debt is held by the public (both individuals and corporations) and they are "less fickle and longer-term investors" than the Turkish banks or mutual funds. This provides a measure of stability, Oztrak observed.

16. (C) Comment: Oztrak's optimistic picture is certainly possible, but it is premised on gradually declining interest rates which in turn requires the GOT to restore its credibility in the markets.
PEARSON